LMCG INVESTMENTS

UNFILTERED

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AFTER THE DELUGE: WHAT TO WATCH

We have experienced a nice bounce in the equity markets year-to-date after the fourth quarter 2018 malaise, although the economic picture is murky at best. As the US government and border wall debate further complicates the near term outlook, we wanted to look past the short-term swings and focus instead on the big issues over the next five years. In our opinion, we think the following issues loom large for capital markets investors:

ECONOMY

Could there be a 1991 redux as tax cut decline in revenues meets budget cut impasse?

During the era of the Reagan/Bush tax cuts, a President had to own up to the fact that government tax revenue shortfalls could not be made up by budget cuts. Backpedaling on the "no new taxes" pledge probably cost George H.W. Bush the election in 1992. We are concerned that the divided Congress is now more incapable of arriving at budget discipline than in 1991. A recession, as the US had in 1990-1991, could be more difficult to resolve today than it was in 1991, and would be a threat to credit markets and perhaps to the US dollar.

INTEREST RATES

Gradual squeeze – investors have been winning by betting against the return of inflation; we think this approach is like "collecting dimes in front of a steamroller."

Historically, it has taken 12 to 24 months for higher rates to impact an economy. Hawkish US Federal Reserve rate policy coupled with the end of quantitative easing in 2016 and 2017 was making for a difficult bond market throughout much of 2018. In December 2018, bond markets saw some relief as falling interest rates came with a falling equity market. We remain vigilant for a surprise, sharp bond market decline (i.e., interest rate spike) even though it seems implausible after all of these years. Investors who continually bet against the return of inflation (collecting dimes) have been the big winners over the past five years. However, it only takes one time being wrong to devastate the "safe" portion of your portfolio.

Surprise interest rate shocks have been very rare since the mid-1990s. A relatively small shock in 1994 not only put many bank cash funds into the position of "breaking the buck" (recognizing losses in their "safe cash" portfolios), but led to the disaster of the "Tequila Crisis" as Mexico and other fragile emerging markets devalued their currencies dramatically in 1995.

REGULATORY ISSUES

The monopoly platform vs. fair competition and privacy: It matters more to US markets.

Major global industries have become highly concentrated, and investors are taking notice. The technology industry cycle of "private to public" has been disrupted by private transactions made by increasingly dominant industry leaders. Remember that it was just over 100 years ago that Standard Oil was broken up, and nearly 40 years since the telephone monopoly of AT&T was broken into the baby bells. Antitrust waves in the United States are episodic through history, and were successful at stimulating competition.

The European Union is already far more vigilant than the US on this issue, sometimes mixing in security and privacy issues in with anti-monopoly vigilance. The security issues surrounding the recent arrest of a Huawei executive in Canada also brings another anti-concentration weapon into play – national security in cross-border ownership. Analysts who predicted that the internet would create "winner take all" in the new economy were right; but now we are entering the next act.

FOREIGN MARKETS

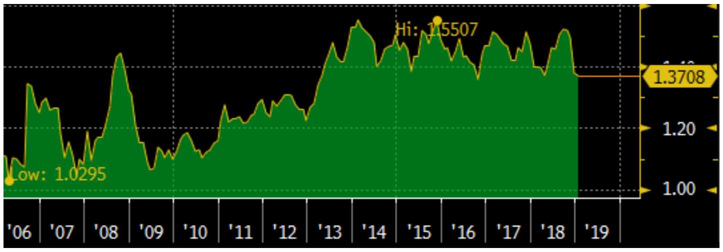
Selection among foreign markets becomes more important.

Most foreign markets are cheaper than the United States market by leading measures, as shown in the chart below, and are long overdue to lead performance. Some markets deserve permanent discounts, but other markets are in a fundamentally better financial position to outperform. Our favorite asset class for culling is within the "emerging markets." There are markets that are now no longer considered "emerging" but are in decline in both population and economic growth. Central European markets are in particular jeopardy of stagnation, but can other markets justify "emerging" as their category name implies? Selecting foreign investments that are not only not "emerging," but are falling into decline and political uncertainty, seems like the logical next phase of smart beta.

The Premium of US Equities to Emerging Markets

Price/Earnings Multiple – MSCI Emerging Markets divided by Russell 1000

12/31/2005-1/31/2019



French, British and German turmoil – political resolution on the way.

Brexit will resolve itself, one way or another, as Germany attempts to establish new leadership. Italy is brought into line with the EU budget as Spain and Ireland continue the long road to stability and growth.

Sure, it can all fall apart again, and everyone is worried about the integrity of the eastern side of Europe as the US withdraws support from NATO. But the stagnation may soon give way to opportunity.

Mexico and Brazil – Left vs Right? No, it is about integrity and unity.

Latin America appears to be split in political direction, but the colossal failure of Venezuela has brought a sense of caution to the region. Both Presidents Andres Obrador "AMLO" in Mexico and Jair Bolsonaro in Brazil are bound together by a populist sentiment fighting corruption and violence. Can Latin America find the leadership that can turn the tide? These markets are finding footing as 2019 opens and the success at building domestic and global trust will likely matter far more than whether the politics are left or right.

Brazil will prove again that having a country in turmoil is better than a currency with no country at all.

We published a holiday *Unfiltered* in 2017 entitled "Bitcoin versus Brazil" in which we questioned whether a currency that is unblemished by having a country attached to it (cryptocurrencies like Bitcoin) was better than, say, the Brazilian Real, a currency with a county attached that is struggling mightily with corruption and economic inequality. If 2018 says anything about the future, it says go with the currency with a country. Brazil's election turned around its stock market and currency for now. Those who bet on Bitcoin lost over 70% in 2018.

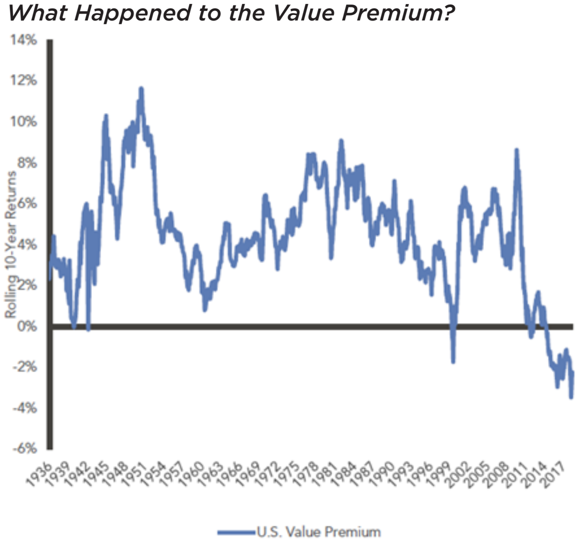
STYLE OPPORTUNIES AND RISKS

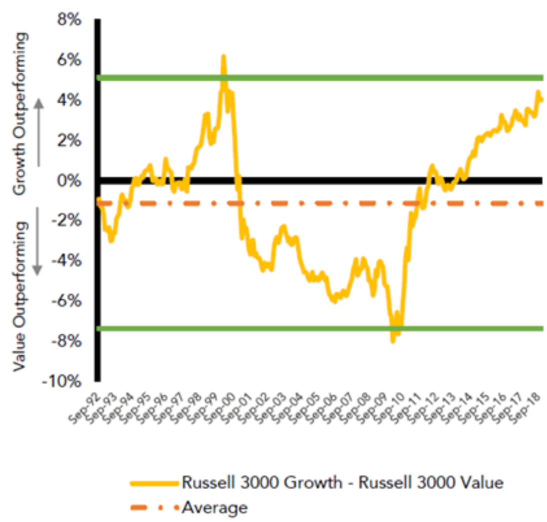
Will value investing outperform when foreign investing outperforms?

The long-term chart below, published by investment consultant Marquette, summarizes the beating taken by value stocks over the past decade. The cyclicality is hard to ignore.

These charts clearly demonstrate the growth versus value dominance recently. We think a style reversal could be a key emerging theme. But we want to make a second point as well: there is a relationship between lagging value stocks and lagging foreign markets compared to US growth stocks. That could lead to a reversal in the US equity versus non-US equity dominance. In fact – we think it's an important enough theme to build out the case for it in the next *Unfiltered*. Look for it at the end of the month.

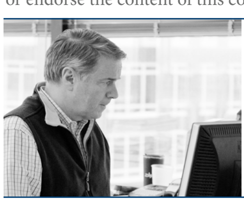
What Happened to the Value Premium?





Source: Kenneth French Data Library, eVestment; December 31, 1926 – November 30, 2018. U.S. value represented by Fama/French HML.

MarquetteAssociates



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